No. 14,912

IN THE

United States Court of Appeals

For the Ninth Circuit

ANNE G. MOHOLY, as Administratrix of the Estate of Philip F. Moholy, Deceased, and ANNE MOHOLY,
Appellants,

vs.

UNITED STATES OF AMERICA,
Appellee.

On Appeal from the Judgment of the United States District Court for the Northern District of California.

BRIEF FOR THE APPELLEE.

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UNITED STATES OF AMERICA,

Appellee.

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BRIEF FOR THE APPELLEE.

OPINION BELOW.

The memorandum opinion of the District Court (R. 14-19) is reported in 132 F. Supp. 32.

JURISDICTION.

This appeal involves income taxes for the calendar year 1949. The amount originally sued for was $209, which was paid on or before March 15, 1950. (R. 80.)

Claim for refund was filed on March 14, 1953. (R. 7-9.) More than six months having elapsed without action by the Commissioner on the claim for refund (R. 6, 11), on April 13, 1954, the taxpayers brought an action in the District Court for recovery of the taxes paid, within the time provided by Section 3772 of the Internal Revenue Code of 1939 (R. 3-9). Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. On August 4, 1955, judgment was entered for the taxpayers by the District Court in the amount of $134, plus interest. (R. 20-21.) Within sixty days and on September 22, 1955, a notice of appeal was filed by the taxpayers. (R. 21.) Accordingly the amount of federal income taxes here involved is $75. This Court has jurisdiction in this matter by reason of 28 U.S.C., Section 1291.

QUESTION PRESENTED.

Whether $489.17 paid in 1949 to taxpayer as "sick leave with full pay," is excludible from gross income as "amounts received through * * * health insurance" within the meaning of Section 22(b)(5) of the Internal Revenue Code of 1939.

STATUTE INVOLVED.

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

* * * * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income

and shall be exempt from taxation under this chapter:

* * * * * * *

(5) [as amended by Secs. 113 and 127, Revenue Act of 1942, c. 619, 56 Stat. 798] *Compensation for injuries or sickness.*—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 23(x) in any prior taxable year, amounts received through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness, and amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country;

* * * * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

STATEMENT.

The pertinent facts relevant to the sole issue presented here on appeal appear as follows:

The decedent, Philip Moholy (hereinafter referred to as taxpayer as is also sometimes the appellants), was, during the calendar year 1949, a captain in the fire department of the city and county of San Francisco. (R. 14.) Together with his wife, Anne Moholy, taxpayer timely filed a joint income tax return for that year with the then Collector of Internal Revenue at San Francisco, California. (R. 4.) For purposes

of filing the return, the spouses were on a calendar year cash basis of accounting. (R. 5.) Included in gross income reported was $489.17 received as sick pay for a period of 35 days during which taxpayer was ill with bronchitis and unable to work. (R. 14)[1]

As shown in the appendix to taxpayer's brief, the $489.17, here in issue, was received by taxpayer as "sick leave with full pay" pursuant to the provisions of the SICK RULE (pp. ii-ix) adopted by the San Francisco Fire Commission on April 18, 1945, and in effect during the calendar year 1949. Authorization for the granting of sick leaves, by rule of the Civil Service Commission "subject to the approval of the board of supervisors," appears in Section 153 of the charter of the city and county of San Francisco. (pp. i-ii.) Under Section 11 of Rule 32 of the Civil Service Commission, the SICK RULE here in effect (pp. ii-ix), provides, *inter alia* for "sick leaves * * * with full pay" under qualifying circumstances (p. iii). Two weeks' annual sick leave with full pay up

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[1]Actually, taxpayer had included in gross income on the 1949 joint return an additional amount of $900 received as disability pay from the city and county of San Francisco. This amount covered a period of 68 days during which he had been incapacitated by reason of being thrown from a fire truck while answering an alarm. (R. 14.) His claim for refund in the amount of $209, filed on March 14, 1953 (R. 5), was based on the contention that both this disability pay and the $489.17, here in issue, should be excluded from gross income under Section 22(b)(5) of the Internal Revenue Code of 1939 (R. 14). At the trial below, the Government conceded that the $900, received as disability pay, was properly excludible. (R. 15.) Accordingly, while the District Court held below that the $489.17, received as sick pay, was includible in ordinary income (R. 18), the judgment (R. 20-21) permitted taxpayer to recover $134, plus interest, thus, as stated, leaving $75 as the amount of tax here in dispute.

o a cumulative maximum of not to exceed six months s permitted to firemen who have been continuously mployed for one year or more. (pp. iii-iv.) Sick pay, o granted, is indicated on pay rolls and time sheets y the letters "S.P." (p. iv.) To comply with the ule, it is incumbent upon the fire department mem- er to report illness immediately to the battalion hief (p. vi), to file physician's certificates with the lepartment physician (p. vii), and to receive the prescribed visits from the department physician (p. ii) and the battalion chief (pp. viii-ix) when unable o report to the department physician in person (p. ii). Failure to comply with the rule's requirements s cause for investigation and the possible lodging of formal complaint by the battalion chief. (p. ix.)

SUMMARY OF ARGUMENT.

The continuation of taxpayer's regular salary by he San Francisco Fire Department as "sick leave vith full pay" was compensation for services which s not exempt from income tax under Section 22(b) (5) of the Internal Revenue Code of 1939 as "amounts eceived through * * * health insurance." Such sick eave payments, made in qualifying cases as an in- cident of the recipient's Civil Service status, do not partake of the nature of health insurance. As a prac- tical matter of common, everyday speech, the con- tinuation of an employee's salary by his employer during absence on account of sickness is not known

as health insurance. Moreover, the SICK RULE of the San Francisco Fire Department, while clearly evidencing a design to function as an implementing feature of the department's compensation plan for personnel, lacks the fundamental characteristics of health insurance. Neither were the payments "amounts received through * * * health insurance" within the legislative intendment of Section 22(b)(5) of the 1939 Code. In enacting the section, Congress adopted a statutory pattern which makes no provision for the exclusion of payments such as are here before the Court. Although Section 22(b)(5) provides for an exemption from income tax, the taxpayer must bring herself clearly within its terms. This she has failed to do under the facts obtaining, the statute, and the decided cases. In addition, the established criteria which are applied administratively to test for statutory compliance clearly buttress the correctness of the District Court's decision below.

ARGUMENT.

THE DISTRICT COURT CORRECTLY HELD THAT $489.17 PAID TO TAXPAYER IN 1949 BY THE SAN FRANCISCO FIRE DEPARTMENT AS "SICK LEAVE WITH FULL PAY" IS NOT EXCLUDIBLE FROM GROSS INCOME AS "AMOUNTS RECEIVED THROUGH * * * HEALTH INSURANCE" WITHIN THE MEANING OF SECTION 22(b)(5) OF THE INTERNAL REVENUE CODE OF 1939.

We submit that the District Court correctly held (R. 18) that the sick leave pay received by taxpayer in 1949 did not qualify for exclusion from gross income as "amounts received through * * * health in-

surance" within the meaning of Section 22(b)(5) of the Internal Revenue Code of 1939, *supra*.

A. The sick leave payments herein made do not partake of the nature of "amounts received through * * * health insurance".

As a practical matter of common everyday speech, continuation of an employee's salary by his employer during absence on account of sickness is not known as health insurance. Just like the continuation of salary during vacations, it is part of the compensation paid for past and prospective services.[2] As the court below recognized (R. 18), it is a clear distortion of the statutory phrase "amounts received through * * * health insurance" to include within its meaning paid sick leave such as that before the Court. Words of a statute are to be interpreted in their ordinary and everyday meaning. *Crane v. Commissioner,* 331 U.S. 1, 6.

There can be no question but that the payment here in issue was not received through health insurance but, instead, constituted additional compensation for services. In *Beck v. Penna. R. R. Co.,* 63 N.J.L. 232, 43 Atl. 908, the defendant railroad company defended a personal injury action by one of its employees on the ground that the employee's membership in a relief fund maintained jointly by the employer and its employees released the employer from liability. The relief fund provided for the payment of definite amounts to employees disabled

[2]There is a presumption that any beneficial payment to an employee beyond his salary is additional compensation. *Van Dusen v. Commissioner,* 166 F. 2d 647, 650 (C.A. 9th).

by accidents or sickness. The court held that the contract pursuant to which the employee became a member of the relief fund was valid and operated to release the employer from liability. It rejected the employee's contention that the contract was prohibited by provisions of the New Jersey laws relating to insurance. It held that the contract was not one of insurance, saying (pp. 241-242):

> A contract of similar import with a railway company which had established what was called a railway insurance society, was held by the Court of Queen's Bench to be a labor contract between employer and employe. *Clements v. L. & N.W. Railway Co.*, 2 Q.B. 482 (1894). The contract before us is *the contract of an employer with an employe respecting the compensation the latter shall receive for his labor,* and the manner in which it shall be accounted for and paid for his relief or the benefit of his beneficiaries. *The payment by the company of the expenses of management and of contributions, to make up deficiencies is in the nature of additional compensation for labor* to those of its employes who enter into this contractual relation with it. (Emphasis supplied.)[3]

Not only is paid sick leave such as that before the Court not known as health insurance in plain, ordinary, everyday speech but it lacks the fundamental characteristics of health insurance. Individual and group health insurance is not written for more than 75 per cent to 80 per cent of the insured's individual

[3]See also *Sherer v. Smith*, 85 Ohio App. 317, 320, 88 N.E. 2d 426, 428, which is in accord.

salary. Faulkner, Accident and Health Insurance (1940) states (p. 132):

> The carriers have set as the maximum limit for which coverage will be granted weekly indemnity equal to 75 or 80 per cent of the applicant's earned income. If the insured has other insurance applicable to the risk, the amount granted will be reduced accordingly. The insured is made a coinsurer to the extent of 20 per cent of his earnings in the hope that malingering will be minimized. With the insured carrying approximately one-fifth of his own risk, it becomes quite as much to his own interests as the insurance carrier's for the disability to be terminated as quickly as possible.[4]

This fundamental and practical feature of health insurance is absent from the wage continuation formula before the Court which provides (Taxpayer's Br. iii-iv) for "sick leave *with full pay*" (emphasis supplied) for as long as six months, depending on the fireman's length of service with the department.

In addition, the SICK RULE of the San Francisco Fire Department, here before the Court (Taxpayer's Br. ii-ix), clearly evidences a design to administer the wage continuation formula as an implementing feature of the department's personnel policy. Patently, such a purpose is consistent with the fact that the Fire Commission's rules are "subject to the approval of the Civil Service Commission." (Taxpayer's Br. ii.) Since the SICK RULE, at most,

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[4]Accord: Sommer, Manual of Accident and Health Insurance. 51-53.

is an administrative addendum to earlier acquired incidents of Civil Service status (which obviously included the right to appeal to the Civil Service Commission under the administrative procedure obtaining), it follows as a matter of course that "nothing herein contained shall abrogate the right * * * to appeal to the Civil Service Commission * * *." (Taxpayer's Br. vii.) That disciplinary measures taken by the department in connection with its administration of the SICK RULE might furnish grounds for a member's possible invocation of this basic appeal right may logically be inferred from the provision that no "salary or compensation" will be paid for sickness incurred "through intemperance, vicious habits, immoral or unlawful acts or * * * reckless negligence * * *" (Taxpayer's Br. viii) and the provision that, in event of a member's failure to comply with either the rules or the directions of the department physician, the battalion chief may, in warranted cases, file a formal complaint (Taxpayer's Br. ix). In other words, the SICK RULE here before the Court, unlike health insurance, is expressly administered as an integral feature of the department's *compensation* plan for its members.

On the negative side, the glaring dissimilarity between the SICK RULE and health insurance is highlighted even more when attention is directed to what the RULE does *not* provide. Limited only to the normal Civil Service right to appeal when "salary or compensation" is cut off, the RULE, unlike health insurance, provides no direct right to use for claimed

benefits. No premiums are charged. No trusteed fund or fund of any kind is maintained to provide for benefits. Obviously, the San Francisco Fire Department does not write insurance as part of its public function; neither is it licensed as a health insurer. The most that can be said is that the appropriation out of which members' salaries are paid is drawn upon, in qualifying cases, to continue full salary payment during periods of sickness.

There is, moreover, *no distribution of risk.* It is fundamental that insurance involves both "risk-shifting *and* risk-distributing." (Emphasis supplied.) *Helvering v. Le Gierse,* 312 U.S. 531, 539.[5]

If it be assumed that, under the SICK RULE, the risk that the department would not continue a member's salary during sick leave was shifted to the department, an assumption that is difficult to square

[5]Contrary to taxpayer's attempt to spell out an insurance contract within the meaning of Section 22 of the California Insurance Code (Br. 6-7), the California Supreme Court has held that a plan of defraying the expenses of medical care incurred by an organization's dues-paying members is not "disability insurance" within that definitional section. *California Physicians' Service v. Garrison,* 28 Cal. 2d 790, 172 P. 2d 4. If such a plan is not insurance under California law, *a fortiori,* sick leave pay, with no contributions being made, could not be. See the California Supreme Court's opinion, cited *supra,* where the court stated, with respect to an insurance contract's requirements that there be both a risk of loss "and an assumption of it by legally binding arrangements by another" (p. 804):

> Even the most loosely stated conceptions of insurance and indemnity require these elements. Hazard is essential and equally so a shifting of its incidence. If there is not risk, or there being one it is not shifted to another or others, there can be neither insurance nor indemnity. Insurance also, by the better view, involves distribution of the risk, but distribution without assumption hardly can be held to be insurance. [Citations omitted.]

with the insurance concept of risk-shifting, there was *no distribution* of such risk among the members. Rather, the entire cost of the sick leave pay was borne by the department's salary appropriation. The risk remained *undistributed.* As the Court of Appeals for the Second Circuit stated in *Commissioner v. Treganowan,* 183 F. 2d 288, 291, certiorari denied, *sub nom. Estate of Strauss v. Commissioner,* 340 U.S. 853:

> Risk distribution, on the other hand, emphasizes the broader, social aspect of *insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group.* By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. *The process of risk distribution, therefore, is the very essence of insurance.* (Emphasis supplied.)

The rationale of the District of Columbia Circuit's decision in *Waller v. United States,* 180 F. 2d 194, is closely in point. There the taxpayer urged that his retirement pay, received under a federal statute as a result of his retirement for physical disability incurred in line of duty, was actually, or in the nature of, workmen's compensation "received * * * under workmen's compensation acts, as compensation for personal injuries or sickness" within the terms of Section 22(b)(5) of the Internal Revenue Code of 1939. (P. 195.) The court rejected the taxpayer's argument and denied the claimed exemption. It said (p. 196):

> *Retirement pay is not known as workmen's compensation, nor is the latter known as the former.* Had Congress intended to exempt retirement pay

from taxation, it would not have left the effectuation of its intention to the dubious fate of rulings by administrators or courts that such pay is free of tax burden because workmen's compensation is expressly made so. (Emphasis supplied.)

Equally, continuation by the department of the member's full salary during sick leave "is not known" as health insurance, "nor is the latter known as the former."

The reasoning of the *Waller* case was incisively applied by the District Court below, as follows (R. 17-18):

> All this is interesting. But the problem is not whether the system setting up these payments is like health insurance. The problem is whether the payments are "amounts received through accident or health insurance" as those words are used in the Act. While their meaning in the statute is not free from doubt, I take it that the words were used in their ordinary service. Cf. *Waller v. U.S.*, 180 F. 2d 194 (App. D.C. 1950). "Sick leave with full pay" is an ordinary, well understood phrase. "Health insurance" is likewise an ordinary, well understood phrase. Taking their ordinary meaning they are not the same. Sick leave pay is just not "amounts received through health insurance".

B. Under the Internal Revenue Code of 1939 which is here applicable, Congress clearly did not provide for the exemption of sick leave payments such as are here before the Court.

If Congress had wished to exempt from taxation salary payments received from an employer during sick leave, it could readily have said so expressly. Indeed, it may be asked why Congress in enacting Section 22(b)(5) qualified the exemption by limiting it to amounts received as compensation for personal injuries or sickness "through accident or health insurance or under workmen's compensation acts". If Congress had intended to exempt from taxation other payments, such as those made by the San Francisco Fire Department in the present case, it could readily have done so by deleting the phrase "through accident or health insurance or under workmen's compensation acts." The section would then read, as the taxpayer, in effect, urges this Court to read it, so as to exempt "amounts received as compensation for personal injuries or sickness."

In fact, Congress recognized that salary payments made by an employer to an employee during sick leave were not amounts received through accident or health insurance or under workmen's compensation Acts when it extended the exemption of Section 22(b)(5) in 1942 to "amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country." If, as the taxpayer contends and contrary to the holding below, the continuation of an employee's salary by the employer during sick leave constitutes amounts received through health

nsurance then there was no need for Congress to mend Section 22(b)(5) in 1942 and extend the xemption, as it did, to a limited and specified cate- ory of paid sick leave.

A statute, such as the Internal Revenue Code of 939, is to be construed as a whole and not as if each f its provisions were independent of the others.)ther pertinent provisions in the Code may be con- ulted to determine the true meaning of the statutory anguage in question. *Alexander v. Cosden Co.,* 290 J.S. 484, 496.

In this connection, Section 22(b)(1), which is sim- lar to Section 22(b)(5), furnishes a guide to the neaning of the phrase "health insurance" as used n Section 22(b)(5). Section 22(b)(1) exempted rom taxation, prior to 1951:

> (1) *Life insurance.*—Amounts received under a life insurance contract paid by reason of the death of the insured, * * *

This section was amended by Section 302 of the Revenue Act of 1951, c. 521, 65 Stat. 452, to exempt:

> (1) *Life insurance, etc.*—Amounts received—
>
> (A) under a life insurance contract, paid by reason of the death of the insured; or
>
> (B) *under a contract of an employer providing for the payment of such amounts to the beneficiaries of an employee, paid by reason of the death of the employee;*
>
> * * * The aggregate of the amounts excludible under subparagraph (B) by all the beneficiaries of the employee under all such contracts of any

one employer may not exceed $5,000. (Emphasis supplied.)

The reason for this amendment to Section 22(b)(1) of the Code is found in S. Rep. No. 781, 82d Cong., 1st Sess., p. 50 (1951-2 Cum. Bull. 458, 493):

> Section 22(b)(1) of the Code excludes from gross income amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or otherwise. *However,* by its terms, this provision is limited to life insurance payments, and the exclusion does not extend to death benefits paid by an employer by reason of the death of an employee. (Emphasis supplied.)

It is thus apparent that when Congress, having exempted from income tax "amounts received" under a "life insurance contract," wished also to exempt amounts received from an employer under a contract by reason of the death of an employee, it found it necessary to do so expressly. Likewise, if Congress had desired to exempt from taxation sick leave payments by an employer to an employee it would have added a subparagraph to Section 22(b)(5) similar to 22(b)(1)(B). This subparagraph might read, if patterned after Section 22(b)(1)(B), as follows:

> Amounts received—
>
> * * * * * * *
>
> (B) under a contract of an employer providing for the payment of such amounts to an employee, as compensation for injuries or sickness.

anguage might also be included limiting the aggre-
ate amount excludible, similar to that contained in
ie last sentence of Section 22(b)(1).

The parallel is striking and altogether persuasive
at sick leave paid by an employer is not health in-
rance. Otherwise, death benefits paid by an em-
loyer pursuant to contract would have been
Amounts received under a life insurance contract"
ithin the meaning of Section 22(b)(1) prior to its
nendment in 1951, and the addition of Section 22(b)
1)(B) by the Revenue Act of 1951 would have been
n empty gesture.

Indeed, Congress, in continuing recognition of the
ifference between insurance and payments, such as
iose in question, made by an employer to his em-
loyees or his employees' beneficiaries, provided in
ie Internal Revenue Code of 1954 for the prospective
xemption from income tax of amounts received
irough health insurance (Section 104(a)(3) (26
.S.C. 1952 ed., Supp. II, Sec. 104)) and amounts
aid to an employee under his employer's wage con-
nuation plan on account of sickness (Section 105(d)
26 U.S.C. 1952 ed., Supp. II, Sec. 105)). Thus, the
attern followed by Congress in 1951 in amending
ection 22(b)(1) of the Internal Revenue Code of
939 was repeated by Congress in 1954 in enacting
he successor to Section 22(b)(5) of the Internal
Revenue Code of 1939. Now amounts received by an
mployee under his employer's wage continuation
lan in 1954 and later years may be exempt from in-

come tax, subject to limitations as to amount similar to those provided when Section 22(b)(1) of the Internal Revenue Code of 1939 was amended in 1951.

As the District Court below succinctly observed (R. 18):

> If Section 105(d) of the Internal Revenue Code of 1954 has any relation to this problem at all, it shows that Congress can use plain words to exclude these types of payment from gross income.

C. The decided cases.

The issue of federal statutory construction here on appeal has not previously been passed upon by this Court. Consequently, the Seventh Circuit's decision in *Epmeier v. United States,* 199 F. 2d 508, which furnishes the keystone underpinning for taxpayer's instant appeal (Br. 8-17),[6] is not binding in this Circuit.

In the *Epmeier* case, the Lincoln National Life Insurance Company, the employer, a company having statutory authority to insure health risks, and, in fact, writing disability insurance as part of its business, had an employees' sickness benefit plan which granted

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[6]The taxpayer also relies (Br. 14-15) on *Herbkersman v. United States,* 133 F. Supp. 495 (S.D. Ohio), now pending on appeal to the Sixth Circuit, and (Br. 15-17) on *Haynes v. United States* (N.D. Ga.), decided January 28, 1955 (1955 C.C.H., par. 9231), and now pending on appeal to the Fifth Circuit. Both of these cases were decided on the authority of *Epmeier v. United States, supra.* However, see *Branham v. United States,* 136 F. Supp. 342 (W.D. Ky.) (now pending on appeal to the Sixth Circuit), which distinguished the *Epmeier* case and held that the sick leave payments there before the court did *not* qualify for exemption under Section 22(b)(5).

kness and death benefits to eligible employees. Full-
ne salaried employees were eligible to receive bene-
s equal to a percentage of salary for a period of
ne based on length of employment. The plan stated
at, as a general rule, any employee who was sick
disabled beyond the period of time during which
e benefits were paid under the plan would not be
rther compensated, but would be removed from the
yroll. If an employee received workmen's compen-
tion, he would be paid only the difference between
ch amounts and what he would otherwise receive
der the plan. As a condition to the receipt of bene-
s, the plan also required cooperation by the em-
oyee with his attending physician. Employees con-
buted nothing to the plan, which was voluntary
d not required by any state statute. The company
served the right to change the plan.

Epmeier, the employee, apparently received $300
onthly for six months under the plan. Such amount
ualed what his normal salary would have been
r the same period of time. Later he instituted suit
r refund of the federal income tax on this amount
the theory that the sickness benefits so received
ere excludible from gross income as "health insur-
ce" under Section 22(b)(5). Both parties agreed
at a requisite of health insurance was a contract
tween insurer and insured. In the District Court,[7]
e Government prevailed. Basing its decision on the

[7] *Epmeier v. United States* (N.D. Ind.), decided February 28, 52 (1952 C.C.H., par. 9261), reversed, 199 F. 2d 508 (C.A.).

plan's recurrent use of the term "free benefits," the provision that the employer could change the plan at will, and the absence of any contributions by employees, the District Court concluded that the benefits were not insurance because they were mere payments in the nature of compensation moving from employer to employee, and that they were, therefore, taxable. The District Court did not believe that Epmeier could legally enforce his claim to sickness benefits.

On appeal, the Seventh Circuit reversed the District Court and permitted the exclusion. Rationalizing that a formal contract is not necessary when the benefits plan can be viewed as part of the employment contract, the court adopted a novel approach and analyzed the sickness plan to ascertain similarities to orthodox accident or health insurance policies. Such allegedly shared characteristics so ascertained included the requirement of employee medical examinations; the basing of sickness benefits on salary and length of service; the provision for termination of benefits; the provision for successive illnesses; and the requirement that an employee cooperate with his attending physician. The plans' recurring use of the word "free" in describing the benefits was brushed aside as simply indicating that the benefits were furnished free of any money advancement. The employer's reserved right to alter the plan was discounted on the grounds that the employer could not make a change once liability had attached and, if any change did not suit him, an employee could quit. With respect to the interpretation to be accorded Section

(b)(5), the Seventh Circuit concluded (p. 511) at the legislative intent was "to relieve a taxapayer ho has the misfortune to become ill or injured, of e necessity of paying income tax upon insurance nefits received to combat the ravages of disease or cident."

We submit that the decision reached in the *Epmeier* se, *supra,* is both incorrect and based upon an erro- eous construction of the legislative intent underlying ection 22(b)(5) of the 1939 Code. See Point B, *pra,* wherein we demonstrate that under the 1939 ode Congress clearly did not provide for the exemp- on of sick leave payments such as are here before e Court. In addition, the original predecessor to ection 22(b)(5) was enacted because it was doubtful hether amounts received through *health insurance* ere required by statute to be included in gross ncome. H. Rep. No. 767, 65th Cong., 2d Sess. (1918), p. 29-30 (1939-1 Cum. Bull. (Part 2) 86, 92). In he income tax statutes before that time[8] income was efined to include "income derived from salaries, ages, or compensation for personal service of what- ver kind or in whatever form paid." There could ave been little doubt that amounts received by an mployee *as the continuation of his pay* during his bsence on account of sickness fell within the defini- on of taxable income. In fact, the reason for the oubt in 1918 as to the taxability of the proceeds of

[8]Section II B, Income Tax Act of 1913, c. 16, 38 Stat. 114, 67; Section 2(a), Revenue Act of 1916, c. 463, 39 Stat. 756, 57; Section 1200(a), Revenue Act of 1917, c. 63, 40 Stat. 300, 29; Section 213, Revenue Act of 1918, c. 18, 40 Stat. 1057, 1065.

health insurance was that it was thought that such proceeds were capital receipts. 31 Op. A.G. 304, 308. This reason could have had no application to *additional compensation* paid by an employer during a period of sickness, which was and is income, not capital. Thus payments such as those now before the Court clearly are *not* amounts received *through health insurance* within the intendment of Section 22(b)(5).

Moreover, a comparison of the factual circumstances of the instant case with those obtaining in *Epmeier, supra,* highlights the fallacy of the Seventh Circuit's attempt to arrive at a statutory interpretation based upon the additive similarities allegedly discernable between a system providing for sick leave and a commercial policy of health insurance. In a Civil Service setting, as contrasted to the sick benefits plan of a private employer, the characteristics fastened upon by the Seventh Circuit in *Epmeier* to classify payments as made through health insurance —*viz.,* that an employee (a) shall receive a physical examination, (b) shall, while on good behavior, continue to draw full salary during illness, for a limited time based on length of service, and (c) shall cooperate in such event with the attending physician—stand revealed as ambiguous criteria equally non-conclusive for purposes of classifying *either* regular salary *or* continued sick leave salary as amounts received through health insurance. In point of fact, both types of payment are included in the Civil Service compensation package and the civil servant's right to con-

ue to draw regular salary not yet earned is no
s nor no more enforceable than is his right to
w accumulated sick pay. Each is conditioned on
d behavior and on compliance with medical re-
rements, whatever the established standards may
As the District Court stated below (R. 17):

> * * * the problem is not whether the system setting up these payments is *like* health insurance. The problem is whether the payments are "amounts received through * * * health insurance" as those words are used in the Act. (Emphasis supplied.)

n any event, irrespective of whatever weight might
e be accorded the Seventh Circuit's decision in
meier v. United States, supra, the instant case is
arly distinguishable from *Epmeier* on its facts.
has been pointed out above, the Civil Service
ects of the SICK RULE here before the Court
sent a factual setting dissimilar to that arising
the case of a private plan adopted by a commercial
poration. Furthermore, in *Epmeier,* the court
pears to have relied upon the fact that the employ-
insurance company had statutory authority to in-
e health risks and in fact wrote disability insurance
part of its business. Finally, since the problem of
tutory construction is one requiring the application
relevant criteria to individual plans for purposes
determining whether *specific* amounts are received
rough * * * health insurance," each case must be
alyzed on the basis of its own facts.

As was here the case in the court below, the above-indicated approach was taken, we believe correctly, by the District Court in *Branham v. United States,* 136 F. Supp. 342 (W.D. Ky.), pending on taxpayer's appeal to the Sixth Circuit. There, the issue presented was whether an employee of the Standard Oil Company (Kentucky) could exclude an amount received, during illness in 1949, under the provisions of the company's employee and security program. The amount paid was equal to taxpayer's regular salary. The court relied on the following criteria, *inter alia,* in distinguishing the *Epmeier* case, *supra,* on its facts and in holding that the payments made were not excludible under Section 22(b)(5) as "amounts received through * * * health insurance": (1) The employees made no contribution; (2) the company had never maintained a fund from which disability benefit payments were made; (3) all such payments had been charged to operating expenses as payroll cost; (4) there had never been a trust or association which administered the plan; (5) no reserve had ever been set up on the company's books against which disability payments were to be charged; (6) the cost of disability benefit payments had never been determined in advance on an actuarial basis; (7) the company had never been licensed to act as a health insurer; and (8) the plan by its terms constituted a voluntary provision made by the company for the benefit and welfare of its eligible employees, with the result that it did not constitute a contract

nferring a right of action on participants therein. conclusion, the court stated (p. 345):

> In the case at bar, the written benefit plan states at the outset that it is a purely voluntary provision made by the Company for the benefit of its eligible employees and that it constitutes no contract and confers no right of action. Here, the employee pays nothing and the potential loss anticipated by the sickness of an employee is borne entirely by the Company and is in no wise diffused through the group of employees. There is no risk distribution and as quoted with approval in the case of *Commissioner of Internal Revenue v. Treganowan,* 2 Cir., 183 F. 2d 288, 291,
>
> " 'The process of risk distribution, therefore, is the very essence of insurance.' "

The administrative position.

As can be observed from the foregoing argument Point C, *supra*), only a relatively small number of ses involving the issue here on appeal have been esented to the courts under the Internal Revenue ode of 1939. The reason for this dearth of litigated ses probably lies in the fact that the federal tax nsequences of the great majority of the accident health insurance plans which are in operation roughout the United States have been made the bject of administrative rulings by the Internal evenue Service. Accordingly, it is believed that a ief statement of the administrative position taken the Commissioner with respect to comparable lans will be of interest.

The Internal Revenue Service's position taken with respect to health insurance under Section 22(b)(5) of the Internal Revenue Code of 1939[9] was developed between 1943 and 1952, the first keystone ruling being G.C.M. 23511, 1953 Cum. Bull. 86. There a company had established a plan under which it might, at its option, pay employees with a specified number of years of service a pension when they retired because of a non-occupational disability. The company would also pay employees with two years or more of service non-occupational disability benefits equal to full or one-half pay for a period of time based on length of service. The Internal Revenue Service ruled that neither benefit was excludible as accident or health insurance under Section 22(b)(5). The Service believed that Section 22(b)(5) did not exclude *all* disability payments, saying (pp. 87-88):

> It is the opinion of this office that Congress intended that only payments, not otherwise specifically excluded, which are truly "insurance" payments should be excluded from gross income under section 22(b)(5), *supra*. To hold otherwise would have the effect of excluding from gross income all payments which are made because of sickness or disability but which are conditioned upon employment and measured by the compensation being paid to the employee. Unless Congress intended that the payments must qualify as "insurance" before they are excluded, it would ap-

[9]The verbatim predecessor of Section 22(b)(5) was enacted in 1918. Section 213(b)(6), Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066. However, Congress never attempted to enact any general definitions of accident or health insurance.

pear that the phrase "through accident or health insurance" would be meaningless and mere surplusage. The fact that the phrase was included indicates that section 22(b)(5), *supra,* is to have limited application.

n its ruling the Service established a contract as *sine qua non* of insurance. No contract was found the pension part of the plan there under considera-on. The payments were to be made at the company's scretion, and the period during which the pension ould be paid was also optional with the employer. he temporary disability payments were not insur-nce for several reasons. The employees made no ontribution to the plan. Nor were the benefits paid rom any fund independent of employer and employee. nd the benefits were measured by regular compensa-on. Furthermore, the benefits were recorded on the ompany's books as a charge to operating expenses.

Up until 1950, G.C.M. 23511, *supra,* represented ne Internal Revenue Service's position, the approach eing one to examine any given plan on its facts o ascertain whether it qualified as "insurance." In 950 and 1951, the Service issued rulings allowing xclusion with respect to three voluntary plans qual-fying under the provisions of the respective state ash benefit Acts of New Jersey, California and New ork. I.T. 4000, 1950-1 Cum. Bull. 21; I.T. 4015, 950-1 Cum. Bull. 23; and I.T. 4060, 1951-2 Cum. ull. 11. Then, in 1952, the Seventh Circuit came own with its unfavorable decision to the Govern-nent in *Epmeier v. United States, supra* (discussed

in Point C above), and the Internal Revenue Service was prompted to reevaluate its position.

Shortly after the *Epmeier* case was decided, the Service published I.T. 4107, 1952-2 Cum. Bull. 73, which dealt with a self-insured plan complying with the New York and New Jersey disability benefits statutes. The plan provided, after a three-day waiting period, for cash benefits equal to regular wages, to employees absent from work because of illness or accident. Though the wages covered both occupational and nonoccupational disability, they were reduced by the amount of any workmen's compensation. The employer retained the sole discretion to determine who should receive benefits, and he could revoke the plan at will within the time limits fixed by the applicable state disability benefits laws. The Service stated that compliance with state disability benefits statutes did not automatically transform a plan into insurance. Since I.T.'s 4000, 4015, and 4060, *supra,* had, in effect, held that such approval did automatically produce insurance, they were modified, effective January 1, 1953. The Service decided that each plan must in itself be insurance to qualify under Section 22(b)(5), thus signifying a return to the basic position earlier taken in 1943 in G.C.M. 23511, *supra.*

Inasmuch as I.T. 4107, *supra,* had been published shortly after the Seventh Circuit's decision in *Epmeier v. United States, supra,* the Service, on March 23, 1953, issued a press release (1953 C.C.H., par. 6136) announcing that the *Epmeier* decision would not be followed in other cases presented for rulings.

e Service stated its belief that the *Epmeier* case d been decided on narrow grounds. It did not be- ve that administrative action should extend the clusion of Section 22(b)(5) to sick leave paid di- tly by an employer to his employees. It did not m proper to exclude sick leave based on regular ges for some employees and to tax other employees full on their wages. Therefore, the Service would d such payments to be taxable.

That the settled administrative position developed th respect to the here relevant Internal Revenue de of 1939 is set out in G.C.M. 23511, *supra,* and T. 4107, *supra,* is borne out by two more recently omulgated rulings, each involving a plan approved der the New York Disability Benefits Law, and th published simultaneously. The first, Rev. Rul. 3, 1953-2 Cum. Bull. 102, found insurance in the se of a self-insured man calling for statutory ben- ts and not a continuation of regular pay, where e employees contributed to a separately trusteed nd and the benefits paid were not made to depend length of service. Under the plan, the employees' ntributions at the date of the ruling had been suf- ient to finance all past benefits paid. The second, ev. Rul. 309, 1953-2 Cum. Bull. 104, reached the con- ary conclusion. Here, with respect to three nonoccu- tional disability benefit plans, where the employer id the cost of all the benefits, the ruling cited I.T. 07 and G.C.M. 23511 in holding that the existence a binding statutory obligation was not sufficient make a plan one of insurance for purposes of

Section 22(b)(5). The criteria applied to determine that the plans did *not* constitute insurance were the following: (a) Employees did not contribute; (b) the benefits, especially in the first two plans, were based on regular pay and, with the exception of the third plan, their duration depended on length of service; (c) the employer did not establish any trust or independent entity into which it made contributions and from which the benefits were paid; and (d) there was nothing to distinguish the benefits from a continuation of regular pay during disability.

It is submitted that, under the criteria outlined above, the decision of the District Court below in the instant case squares with the administrative position adopted by the Internal Revenue Service in ruling on the tax consequences arising under the Internal Revenue Code of 1939 with respect to the payment of sick leave benefits.

In conclusion, it is well to remember that the taxpayer is claiming an exemption from taxation. The Government is not seeking to extend the income tax to payments not previously taxed. It is the taxpayer, rather, who is asking the Court to extend an exemption beyond the scope of its terms. It is fundamental that the taxpayer "must bring himself clearly within the excepted class by proofs which compel or persuade that he is excluded." *Frederick Smith Enter. Co. v. Commissioner,* 167 F. 2d 356, 359 (C.A. 6th); *Bowers v. Lawyers Mortgage Co.,* 285 U.S. 182, 187.

statutory exemption is to be strictly construed. *vering v. Northwest Steel Mills,* 311 U.S. 46, 49. ell-founded doubt as to the meaning of an ex- tion is fatal to a claim of exemption from taxa- *Bank of Commerce v. Tennessee,* 161 U.S. 134,

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CONCLUSION.

or all the reasons set forth above, we submit that decision of the District Court below was correct should here be affirmed.

arch, 1956.

Respectfully submitted,

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